Effective Date: May 24, 1993

COORDINATED ISSUE
MINING INDUSTRY
STRIKE COSTS

ISSUE:

Whether certain administrative and overhead expenses incurred by a mining company during an employee strike as well as depreciation on idled plant and equipment are deductible from gross income from the property for purposes of the 50% taxable income limitation on percentage depletion under I.R.C. § 613(a).

FACTS:

During an employee strike, a mining company will incur substantial expenses even though mine production has ceased. The Service has found that some mining companies are taking the position that such expenses are therefore unrelated to mining activity and should not be subtracted from taxable income from the property in computing the 50% limitation for percentage depletion. The treatment of strike–related expenses as not attributable to mineral production when incurred during a strike and, thus, not deductible from taxable income, will increase allowable depletion. The categories of expenses involved are normally, but not limited to, the following:

a. depreciation on idled plant and equipment
b. amortization
c. various payroll expenses
d. utility expenses
e. lease expenses
f. supervisory salaries
g. engineer salaries
h. clerical and other administrative salaries and expenses
i. indirect costs

The salaries and other payroll costs at issue cover both personnel kept at the mine site to preserve, protect and maintain the property and equipment during the strike and the salaried employees whose costs are charged to the mine while employed at other locations.

CONCLUSION:

It is our position that such strike expenses must be taken into account in determining

the taxable income from the property under I.R.C. § 613(a).

LAW AND DISCUSSION:

I.R.C. § 611 provides that in the case of mines and other natural deposits, there shall be allowed as a deduction in computing taxable income a reasonable allowance for depletion, according to the particular circumstances in each case. In the case of certain natural deposits, I.R.C. § 613 provides that the allowance for depletion shall be a specified percentage of the gross income from the property. The allowance for percentage depletion, however, shall not exceed 50% of the taxpayers taxable income from the property computed without allowance for depletion. I.R.C. § 613(a).

I.R.C. § 613(c)(1) defines the term "gross income from the property", in the case of a property other than an oil or gas well, as the gross income from mining. Treas. Reg. 1.613–4(a) further provides that "gross income from mining" is that amount of income attributable to the extraction of ores or minerals from the ground and the application of mining processes, including mining transportation.

In defining "taxable income from the property" for purposes of I.R.C. § 613, Treas. Reg. §1.613–5(a) provides, in pertinent part:

> The term "taxable income from the property (computed without allowance for depletion)", as used in section 613 and this part, means "gross income from the property" as defined in section 613(c) and §§1.613–3 and 1.613–4, less all allowable deductions (excluding any deduction for depletion) which are attributable to mining processes, including mining transportation, with respect to which depletion is claimed. These deductible items include operating expenses, certain selling expenses, administrative and financial overhead, depreciation, taxes deductible under section 162 or 164, losses sustained, intangible drilling and development costs, exploration and development expenditures, etc. Expenditures which may be attributable both to the mineral property upon which depletion is claimed and to other activities shall be properly apportioned to the mineral property and to such other activities.

In Montreal Mining Co. v. Commissioner, 41 B.T.A. 399 (1940), it was decided that payments in settlement of silicosis claims must be deducted in computing taxable income from the property, because the liability arose out of the taxpayer's mineral production, albeit in an earlier year.

Similarly, in Rialto Mining Corp. v. Commissioner, T. C. Memo 1946–496, the taxpayer argued that back wages, although paid in the current year in accordance with a

National Labor Relations Board settlement, had no relation to the current year's production and, therefore, did not have to be subtracted from gross income from the property. The Court concluded, however, that the settlement "grew from and had an immediate relation" to the taxpayer's mining operation and, therefore, the wages were deductible from gross income from the property.

The Tax Court, in Elk Lick Coal Company v. Commissioner, 23 T.C. 585 (1954), determined that losses sustained by a taxpayer upon abandonment of certain mining equipment and plant components were deductible from gross income in determining taxable income for purposes of computing the depletion allowance. The Court found that the losses were deductible from gross income, because they were directly related to the mining and preparation of coal and were required to be taken into account under Treas. Reg. 111, § 29.23(m)–1(g) under the 1939 Code, which provided that "losses sustained" were to be deducted from gross income.

In Island Creek Coal Co. v. Commissioner, 382 F.2d 35 (4th Cir. 1967), Island Creek Coal purchased business interruption insurance as a supplement to its ordinary fire insurance on its treatment plants to indemnify it for any losses in profits resulting from lost production due to fire damage to its plants. During the taxable year at issue in that case, two of the taxpayer's treatment plants suffered extensive fire damage. The company was reimbursed by its insurance carrier for its lost profits. The taxpayer conceded that the reimbursement was not includible in its gross income from mining, but argued that the related premium payments should also be excluded from its deductions in computing its taxable income from the property. The Fourth Circuit agreed with the taxpayer, holding that the premiums paid for the business interruption insurance were not deductible for percentage depletion purposes. The Court reasoned that taxable income from mining was computed by deducting from gross income from mining all of the mining expenses incurred in the production of that income. Since the insurance reimbursement did not constitute income from mining, the related premium cost was not an expense incurred to produce income from mining. The Court further observed that if a taxpayer has only mining income, all of his ordinary expenses of doing business are probably expenses of mining, which contribute, directly or indirectly, to the realization of that income. On the other hand, if a mine operator receives nonmining income, the expenses which produced that income should be treated as nonmining expenses.

In distinguishing Elk Lick, the Fourth Circuit in Island Creek stated that Elk Lick did not involve a segregation of related receipts and disbursements. The Court explained:

> When mining equipment is purchased, it is an expense of mining; the entire cost is then devoted to mining. The cost must be capitalized and is recoverable for tax purposes only upon subsequent deductions for depreciation and ultimate abandonment. The capitalization requirement, however, simply postpones to

> later years portions of the deduction of the cost of the equipment; it does not change the character of the original cost as an expense of mining. There is a different situation when a profit is realized upon the sale of equipment withdrawn from the mining operation. The profit is not a mining profit. It does not arise out of the extraction and included treatment processes, but withdrawal of equipment from the mining operation does not change the character of the expense of its initial acquisition. It was a mining expense when incurred, and subsequent events do not partially convert it into something else.

Island Creek Coal Co. v. Commissioner, 23 T.C. at 38.

In North Carolina Granite Corp. v. Commissioner, 56 T.C. 1281 (1971), the Tax Court held that the expenses incurred by a taxpayer in resolving Federal income tax controversies were not required to be deducted from gross income from mining. Although the tax controversies were centered on the mining part of the taxpayer's business enterprise, they did not produce any taxable income and, thus, were not "essential to the production of income from mining." The Service nonacquiesced on this issue, since the tax controversy expenses were considered to be indirect administrative expenses that benefited both the taxpayer's mineral property and nonmining operations and an allocation should have made with that portion of the expenses attributable to the mineral property deducted from gross income from mining for purposes of the 50% limitation on percentage depletion. Rev. Rul. 77–179, 1977–1 C.B. 168.

Rev. Rul. 60–74, 1960–1 C.B. 253, holds that charitable contributions made by a mining corporation which are deductible under I.R.C. § 170 may not be deducted in computing taxable income from the property, but payments to charitable organizations which constitute ordinary and necessary business expenses attributable to the mineral property must be deducted in computing the limitation on the percentage depletion allowance.

Likewise, the Service in Rev. Rul. 80–317, 1980–2 C.B. 202, ruled that the payment of damages for breach of contract is not attributable to mining processes and is not deductible from gross income from mining in computing the taxable income limitation. The expenditure was not an ordinary and necessary cost of mineral extraction and was not related to production of income from an extracted mineral, but rather the payment was the result of lack of production.

Mining companies have argued that expenses for salaries, maintenance, depreciation and other costs which continue during a strike are not related to mining processes, since there is no mineral production during a strike. Such expenses are occasioned by the lack of production and are not associated with income from an extracted mineral. It is therefore asserted that these expenses should not be deducted from gross income

for purposes of I.R.C. § 613(a).[1]

The expenses at issue, however, are not extraordinary items incurred because of the work stoppage. Rather, they represent fixed overhead costs which arise in the ordinary course of mining and are included in computing the taxable income limitation for I.R.C. § 613 purposes. These fixed and continuing costs should not take on a different character merely because they are incurred during a shutdown occasioned by an employee strike. The costs are attributable to mining processes regardless of whether the mine is actually operating during the strike.

Moreover, no nonmining income results from these continuing costs. The expenses are incurred basically to maintain the mine for the production of mining income upon the resumption of mining activity following settlement of the strike. Since there is only mining income to be realized, albeit after the strike, all of the ordinary and necessary strike expenses incurred with respect to the mining operation should be considered as contributing, either directly or indirectly, to the production of that income. Therefore, unlike the situations in Island Creek Coal and Rev. Rul. 80–317, cited above, there is no overriding need to segregate and match nonmining expenses with related nonmining income and exclude such nonmining expenses from the computation of the taxable income limitation.

Depreciation taken for the strike period on idled plant and equipment does not warrant special consideration for purposes of determining the percentage depletion allowance. As the Tax Court observed in Island Creek, when mining plant and equipment is purchased, it is a mining expense in the sense that the entire cost is attributable to the mining process. Under established tax practice, the cost of such assets is capitalized and recoverable through subsequent deductions for depreciation or amortization. The initial character of the cost as a mining expense is not altered by either the capitalization requirement or other subsequent events. A temporary, strike–related shutdown of the plant and equipment should, therefore, not change the initial character of the depreciation thereon. Thus, depreciation taken on temporarily idled plant and equipment remains an expense attributable to the mining process within the meaning of Treas. Reg. §1.613–5(a) and thus is excluded from gross income in computing taxable income from the property.

It has also been argued by some mining companies that the temporary regulations under I.R.C. § 263A provide substantial authority, by analogy, for their position that

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[1]Carrying the mining companies' position to its extreme, it could be argued that each time the mining process was interrupted, the costs incurred should be removed from the taxable income limitation. For instance, any down time due to equipment failure during a production shift would not be mining process costs attributable to the mineral property.

strike costs are not required to be deducted from gross income from the property in computing the taxable income limitation. The companies point to the specific references to depreciation on temporarily idled equipment found in Temp. Reg. § 1.263A–1T(b)(2)(v)(F) and strike costs in subsection (I) of that regulation, which except such items from the general requirement that certain direct and indirect costs be capitalized, i.e., charged to a capital account or basis or added to inventory costs with respect to property that is produced or acquired for resale. Temp. Reg. § 1.263A–1T(b). It is concluded that these costs are not considered to be related to production activities for purposes of I.R.C. § 263A, and therefore, these same costs should not be deemed attributable to mining processes under Treas. Reg. § 1.613–5(a).

Our position is that the uniform capitalization rules of I.R.C. § 263A do not provide authority for the exclusion of strike expenses from the computation of the taxable income limitation for percentage depletion. I.R.C. § 263A has no direct bearing upon percentage depletion and does not define the boundaries of the costs which must be included in the computation of the taxable income limitation under I.R.C. § 613. Treas. Reg. § 1.613–5(a) requires gross income from the property to be reduced by all allowable deductions related to mining processes, including mining transportation, with respect to which depletion is claimed. The expenses to be deducted from gross income under Treas. Reg. § 1.613–5(a) are not limited to those production or resale costs that are required to be capitalized under § 263A. In fact, there are several categories of expense which are expressly exempted from capitalization under I.R.C. § 263A, but are still required by Treas. Reg. § 1.613–5(a) to be deducted from gross income from the property for purposes of the taxable income limitation under I.R.C. § 613. The following are examples of such expenses: marketing, selling and advertising expenses; exploration and development expenditures; and losses sustained.